United States Court of Appeals

for the Second Circuit

MEMORANDUM

74-2023

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

CAPITAL COUNSELLORS, INC., CAPITAL ADVISORS, INC., J. IRVING WEISS, ABRAHAM B. WEISS,

Defendants.

CONBOY, HEWITT, O'BRIEN & BOARDMAN

Appellant,

SYDNEY B. WERTHEIMER,

Receiver-Appellee.

On Appeal from the United States District Court
for the Southern District of New York

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

PRELIMINARY STATEMENT

This is an appeal from an order (65a-70a)[1/] issued by the United States District Court for the Southern District of New York (Cooper, J.) denying the request (31a-33a) of appellant Conboy, Hewitt,

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1/ "__a" refers to pages of the appendix of the parties. In addition, "__s" refers to pages of the supplemental appendix of the Securities and Exchange Commission; "Conboy Br. __" refers to pages of the main brief filed by appellant, Conboy, Hewitt, O'Brien & Boardman.

O'Brien & Boardman ("Conboy Hewitt") that its claim for certain legal fees be paid out of the assets of a receivership estate. The legal services for which the fees were being sought had been rendered to defendant Capital Counsellors, Inc. ("Counsellors"), which is a securities broker-dealer, defendant Capital Advisors, Inc. ("Advisors"), an investment advisor closely affiliated with Counsellors, and the two owner-operators of those firms, defendants Abraham B. Weiss and his brother, J. Irving Weiss; Conboy Hewitt had represented the defendants in their unsuccessful resistance to the Securities and Exchange Commission's request (4a) for the appointment of a receiver for the firms. The effect of the district court's order was also to deny Conboy Hewitt's request (33a, 37a-38a) that its claim be granted a preference.

The Commission submits this memorandum in support of the district court's ruling. The Commission recognizes that there is merit to Conboy Hewitt's argument[2/] that unless the attorneys for a defendant resisting receivership are assured of being able to secure payment for their services from the receiver, and on a priority basis, it will be difficult for such defendants to obtain competent counsel; this consideration must, however, be balanced against the countervailing factors, and the Commission is of the view that on the

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2/ Conboy Br. 6-7.

particular facts of this case, an equitable result was achieved. First, as to the law firm's request for a preference, it is difficult for us to see how the law firm, an unsecured, general creditor of Counsellors and Advisors, can equitably be granted a priority over the defrauded customers of Counsellors and Advisors, whose claims are for cash and securities held by the firms for their accounts, and whose claims exceed the assets of the receivership. Second, the court's ruling that Conboy Hewitt's claim was not compensable out of the assets of the receivership was fair since, in our view, the true purpose of defendants' resistance to the Commission's request for the receivership was to enable the Weiss brothers to preserve their equity interest in, and control over, Counsellors and Advisors.

STATEMENT

As indicated above, this appeal is an outgrowth of the Commission's action against the Weiss brothers, Counsellors and Advisors. In its complaint, which was filed March 25, 1971, the Commission alleged that defendants had violated, inter alia, registration and antifraud provisions of the federal securities laws and sought a preliminary and permanent injunction against future violations (4a, 25a). In addition, the Commission requested as ancillary relief the appointment of a receiver for Counsellors and Advisors (4a). The Weiss brothers, who were the founders of Counsellors and Advisors,

officers and directors of the firms and the owners of virtually all of the firm's equity securities (6a-7a),[3] vigorously opposed the appointment of a receiver and retained Conboy Hewitt as defense counsel (3[illegible], 35a, 43-46a, 51a-52a, 59[illegible]).[4]

Defendants' opposition was unsuccessful, for on June 17, 1971, the district court issued an order (30a, 37a, 43a) that preliminarily enjoined the Weiss brothers and their firms from violations of the federal securities laws and appointed a receiver for the firms (28a-30a, 42a-43a).[5] In its opinion (3a-30a), the court found that the Weiss brothers had induced investors to participate in a "Government Bond Plan", an investment scheme devised by the Weisses, by means of promotional literature that was "replete with false and misleading statements" concerning the nature of the plan and the "substantial risks" involved (25a). The court concluded that the Commission had squarely met its burden of establishing a proper showing of need for injunctive relief, and the court considered it imperative to appoint

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3/ While evidence adduced at the hearing on the Commission's request for a preliminary injunction revealed that there was a "limited number" of other shareholders, it seems fair to infer that the number of shares owned by others was de minimis (6a).

4/ The retainer agreement, which was apparently oral, had been entered into in December 1970, when the Commission commenced the investigation that led to the filing of its action (59a). Pursuant to the agreement, Conboy Hewitt represented the defendants both during the investigation (43a-46a, 59a) and in the litigation; Conboy Hewitt was to be paid the reasonable value "of the services . . . to be rendered" (Affidavit of Hobart L. Brinsmade, Esq., a member of the firm, (59a)).

5/ A permanent injunction was issued, upon consent, on June 18, 1973.

a receiver in order to prevent diversion or waste of Counsellors' and Advisors' assets (29a, 30a). The receiver was directed to liquidate the firms and formulate a plan for the distribution of their assets (33s).

On October 25, 1971, during the early stages of the receivership, Conboy Hewitt filed with the district court an "Application For Payment of Fees For Legal Services," in which it requested that the claim it had previously filed with the receiver for the payment of $20,000 in legal fees be granted preferred status (31a-33a). In its supporting papers, Conboy Hewitt asserted that the fees were for the legal services it had rendered to Counsellors and Advisors (33a, 37a, 51a-52a, 63a-64a). Conboy Hewitt submitted a time schedule showing that it had devoted about 420 hours to its representation of defendants, about 50 of which were expended before the Commission brought suit on March 25, 1971 (38a-39a).[6/] The law firm's claim of $2,098 for its pre-litigation services has been allowed as a general claim against Counsellors, pursuant to which the firm will receive a distribution of $41.07 (70s). The Commission's memorandum is addressed solely to Conboy Hewitt's claim for its post-March 25 services, and to Conboy Hewitt's claim for preferential treatment of its entire claim.

6/ The last item on the schedule was dated June 17, the date the court issued its order enjoining defendants and appointing the receiver (38a). All of the work was performed by partners of the Conboy Hewitt firm (34a, 35a, 38a-39a).

The Opinion Below

The district court based its denial of Conboy Hewitt's request for payment upon two factors. First, the court pointed to the well established rule in bankruptcy proceedings that legal services rendered to the debtor in resisting an adjudication of bankruptcy are not allowable under Section 64a of the Bankruptcy Act (11 U.S.C. 104(a)) as a priority claim against the debtor's estate (67a, 68a). The court found the bankruptcy rule applicable because bankruptcy "may result from ineptitude or misfortune" while the instant receivership was imposed not only because of defendants' failure to meet their customer obligations "but also because that failure resulted from fraudulent acts . . . ." (68a). The court's finding in this regard was based also upon this Court's statement in Securities and Exchange Commission v. Alan F Hughes, Inc., 481 F.2d 401, 403 (C.A. 2), certiorari denied, 414 U.S. 1092 (1973), that the bankruptcy rule presented a "compelling" analogy in that case, in which the law firm that had represented a securities broker-dealer in its unsuccessful opposition to an application by the Securities Investor Protection Corporation ("SIPC") for the appointment of a trustee to liquidate the broker-dealer was seeking an allowance from the trustee or from SIPC funds or both for its fees. 7/

7/ In the instant case, there is no evidence that SIPC filed such an application with respect to Counsellors.

The second factor upon which the district court relied was the unfairness of allowing the Weiss brothers "to impose the burden of defending themselves upon customers and other creditors [of Counsellors and Advisors] who have already suffered losses in excess of 4 million dollars" (68a-69a). 8/ The court added that although Conboy Hewitt's services were "of high order and deserving of the legal fees requested," they "in no way furthered the interest of . . . public investors" (69a, 70a).

ARGUMENT

I. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN DENYING THE REQUEST OF APPELLANT CONBOY, HEWITT, O'BRIEN & BOARDMAN THAT ITS CLAIM FOR THE LEGAL SERVICES IT RENDERED TO DEFENDANTS IN OPPOSING THE COMMISSION'S REQUEST FOR A RECEIVER BE ACCORDED A PREFERENCE. 9/

Approximately one month before the district court issued its order denying Conboy Hewitt's application for a preference, the court issued a detailed order (59s-69s) approving the receiver's determinations and recommendations (33s-58s) as to the allowance of claims against Counsellors and Advisors, the priorities to be accorded the various classes of claims and the specific assets out of which these classes should be satisfied.

The order provided for: (a) the splitting of the receivership's $4,958,026 of distributable assets into two funds, a "GBP [Government

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8/ As discussed more fully, infra, pp. 7-8, the district court had found that the receivership assets were approximately $5 million, that the defrauded Government Bond Plan investors had valid claims against the receivership of about $7.3 million and that other customers of defendants had about $1.6 million in valid claims.

9/ As noted earlier, supra, p. 5, this memorandum applies only to the claim for services rendered after March 25, 1971, the date on which the Commission filed suit.

Bond Plan] Fund" of $4,657,439[10] and a "General Fund" of $300,587 (36s, 48s, 50s, 52s-54s); (b) the distribution of the entire GBP Fund among the subscribers to the fraudulent Government Bond Plan -- the court finding that the assets in this Fund were traceable to payments made by subscribers to the Plan, and that these assets were therefore impressed with a trust in favor of these public investors (36s-39s, 55s, 63s, 66s-67s); and (c) the distribution of the General Fund *pro rata* to the Government Bond Plan subscribers to the extent their allowed claims against Counsellors and Advisors exceeded the GBP Fund--*i.e.*, $2,737,704 (36s, 51s, 52s)[11] -- certain other customers of Counsellors and Advisors, who had allowed claims of $1,610,984 (35s, 36s, 52s, 65s), and general creditors, whose claims amounted to $24,649 (36s, 41s, 52s-54s, 67s).

In view of the court's finding that the $4,657,439 of assets comprising the GBP Fund were traceable to, and impressed with a trust in favor of, the Government Bond Plan investors, it would not seem equitable to permit Conboy Hewitt, or anyone else except the GBP

10/ This figure includes $3,033,584 that had already been distributed to GBP subscribers pursuant to the court's order (40s, 49s).

11/ The total net investments of the GBP subscribers amounted to $7,393,888 (52s) and there were $4,656,184 in the GBP Fund (49s). The actual account balances of the GBP subscribers totalled $5,061,882 (52s), which represented total net investments minus the expenses of administering the Government Bond Plan and the amount by which the subscribers' interest costs (the Government securities were purchased on margin (7a-9a)) exceeded the yield of these securities.

investors, to share in that Fund.[12] Accordingly, assuming arguendo that Conboy Hewitt's claim for its post-March 25 services were treated as a general claim -- which it clearly was not[13] -- Conboy Hewitt could look only to the $300,587 General Fund for payment of its claim, and even there it should not have any priority. The GBP subscribers, who entrusted Counsellors and Advisors with their cash and securities are, at the very least, general creditors and "[e]qual, proportional distribution of the assets of . . . a corporation among the general creditors is the purpose and rule of [equity] receiverships . . . ." Torrington Co. v. Sidway-Topliff Co., 70 F.2d 949, 953 (C.A. 7, 1934).[14]

If Conboy Hewitt's legal fees could properly be classified as expenses of the administration of the receivership, the firm's claims for those fees would be entitled to a preference. E.g., Wire Wheel Corp. v. Fayette Bank & Trust Co., 30 F.2d 318 (C.A. 7), certiorari denied, 279 U.S. 873 (1936).[15] But, since those fees are for services remdered in opposition to the appointment of the receiver, services

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12/ The existence of a trust gives rise to a preference -- in favor of the beneficiaries -- in the distribution of the assets of an equity receivership. See 66 Am. Jur. 2d Receivers, § 266.

13/ The court's broad ruling was that the claim for those services "cannot be paid out of the receivership estate" (70a).

14/ Accord, Berthold-Jennings Lumber Co. v. St. Louis I.M. & S. Ry. Co., 80 F.2d 32 (C.A. 8), certiorari denied, 297 U.S. 715 (1936); Southern Ry. Co. v. U.S. Fidelity & Guaranty Co., 87 F.2d 118 (C.A. 5, 1936);

15/ See also § 64(a) of the Bankruptcy Act, 11 U.S.C. 104a, and Sections 6(f)(2) and (b)(1)(A) of the Securities Investor Protection Act of 1970, 15 U.S.C. 78 fff(f)(2) and (b)(1)(A).

which conferred no benefit upon the receivership estate, they should not be viewed as administration expenses. Cf., Securities and Exchange Commission v. Alan F. Hughes, supra, 481 F.2d at 403-404; In re Evenod Perfumer, Inc., 67 F.2d 878 (C.A. 2, 1933), certiorari denied, 291 U.S. (1934); Culhane v. Anderson, 17 F.2d 559 (C.A. 8, 1927); In re Moskowitz, 25 F. Supp. 341 (E.D. N.Y., 1938); In re McMillan Rapp & Co., 36 F. Supp. 664 (E.D. Pa., 1941); Barker v. Southern Bldg. & Loan Assoc., 181 Fed. 636 (N.D. Ala., 1910); In re Christianson, 175 Fed. 867 (D. N.D., 1910); In re Secord, 296 Fed. 231 (W.D. Wash., 1923); In re Goldville Mfg. Co., 123 Fed. 579, 584 (D. S.C., 1903). See also Randolph v. Scruggs, 190 U.S. 533, 539 (1903); Collier on Bankruptcy, ¶ 62.31(1961).

Conboy Hewitt's lack of entitlement to a preference is consonant with the fact that if Counsellors -- the assets of which comprise more than 95 percent of the receivership (36s, 39s) -- had been liquidated under the Bankruptcy Act, rather than via an equity receivership, the law firm's claim would not have received a higher priority than the excess of the claims of the Government Bond Plan investors over the "single and separate fund" provided for in the Bankruptcy Act.

The distribution of the assets of a bankrupt stockbroker firm is governed by Section 60e of the Bankruptcy Act, 11 U.S.C. 96e. The Section provides for the establishment of a "single and separate fund" composed of property (including cash and securities) held by the brokerage firm for "customers," who are defined to include persons who have claims

on account of securities held by the broker for their account. Sections 60e(1) and (2). This fund is to be distributed to such customers on the basis of their respective net equities at the date of bankruptcy. Section 60e(2). If the "single and separate fund" is insufficient to pay the customers' claims in full, they are entitled to share in the "general estate" with the "general creditors." Id.

The classification and distribution plan adopted by the district court in the instant case parallels the scheme established by Section 60e. The "GBP Fund" -- which consists of the cash realized from the liquidation of the Government Bond Plan accounts, a bank account traceable to payments by subscribers to the Plan and commercial paper purchased with funds from that bank account (39s-40s) -- is the equivalent of the "single and separate fund" of Section 60e; the "General Fund" is equivalent to the general estate; and the subscribers to the Government Bond Plan would be "customers" under Section 60e. Not being such a "customer," Conboy Hewitt would, under Section 60e, be at most a "general creditor" entitled to share in the "general estate."[16/]

16/ We are not contending, of course, that Section 60e -- or the Securities Investor Protection Act, whose provisions for the liquidation of stock brokers are similar to those in Section 60e -- should have been applied by analogy here. Compare Securities and Exchange Commission v. Barrett Herrick & Co., 149 F. Supp. 507, 508 (S.D. N.Y., 1957), with In re Rosenbaum Grain Corp., 112 F.2d 315, 319 n.6 (C.A. 7, 1940). See also Esbitt v. Dutch-American Mercantile Corp., 335 F.2d 141, 143 (C.A. 2, 1964), and Lakenau v. Coggeshall & Hicks, 350 F.2d 61, 63 (C.A. 2, 1965). Our point is simply that the fact that Conboy Hewitt would not have received a preference in a bankruptcy or SIPA proceeding tends to indicate that the district court's denial of its request for a preference was fair and equitable.

II. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN RULING THAT CONBOY HEWITT'S CLAIM FOR SERVICES WAS NOT COMPENSABLE OUT OF THE ASSETS OF THE RECEIVERSHIP.

Although Conboy Hewitt rendered the legal services here in question pursuant to a presumably valid agreement, the district court's disallowance of Conboy Hewitt's claim for its post-March 25 services was, we believe, a proper exercise of its broad equitable powers. The principal beneficiaries of those services were, as Conboy Hewitt should have recognized, the Weiss brothers rather than Counsellors or Advisors. While the Weiss brothers' asserted purpose in retaining Conboy Hewitt was to "protect defendants Counsellors and Advisors" (59a), we think it clear that their real purpose was solely that of protecting themselves. Since they evidently owned virtually all the equity stock of Counsellors and Advisors,[17/] and were the chief officers of the firms, the Weiss brothers had a very vital interest in staving off a liquidating receivership. And, as defendants in the action, the Weiss brothers no doubt had an equally strong interest in avoiding being enjoined from violating any provisions of the federal securities laws, for as the Weisses were apparently advised -- and by Conboy Hewitt (59a) -- such a sanction can serve as the ground for the Commission's institution of an administrative proceeding to bar the enjoined person from association with a broker-dealer[18/] or an investment adviser.[19/] There does

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17/ See n. 3, supra, p. 4.

18/ See Section 15(b)(7) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b)(7).

19/ See Section 203(f)(3) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3(f)(3).

not appear to be any individual other than the Weiss brothers who stood to benefit from their retention of Conboy Hewitt.

In view of the foregoing circumstances, we think the district court was correct in stating that Conboy Hewitt should have "provide[d] for adequate assurance of compensation other than through reliance upon a successful defense of the action" (69a). It does not seem fair to require investors who were defrauded by the Weiss brothers to pay any part of what was essentially the Weisses' defense.

Lastly, there is the possibility that Conboy Hewitt does not even have a legally enforceable claim against Counsellors or Advisors for its post-March 25 legal services. On March 25, 1971, the same day the Commission filed its complaint, the district court issued a temporary restraining order (TRO) that, inter alia, temporarily prohibited the Weiss brothers from "engaging in any transactions or undertaking or creating any contractual commitment" on behalf of Counsellors or Advisors (9s). Although this TRO was modified, by consent, on April 2, 1971, to permit the corporate defendants to incur "office and other expenses," the modification required the Weiss brothers to indemnify Counsellors and Advisors for any such expense by depositing in an "Indemnity

Account" an amount equal to the expense; these deposits were to be from the Weiss brothers' "personal assets" (13s, 16s). The TRO was further modified, on May 7, 1971, again by consent. The indemnity fund device was discontinued and the corporations were permitted to incur expenses they deemed necessary provided that they obtained advance approval of a court-appointed fiscal agent (23s). While Counsellors and Advisors were permitted to incur expenses for certain specified activities without obtaining prior approval (16s, 17s, 23s), the retention of counsel was not among these activities. The TRO, as modified, remained in effect (by consent of the parties) until June 17, 1971 when the receiver was appointed (36a, 37a). Conboy Hewitt was aware of the TRO and the two modifications to it, having represented defendants in the negotiations that led to the issuance of the orders (id.).

There is no evidence of the Weiss brothers having deposited any funds in the Indemnity Account to cover the expenses of Conboy Hewitt's post March 25 services or of defendants having requested -- or obtained -- the fiscal agent's approval to incur expenses for those services. Accordingly, there is serious doubt as to whether Conboy Hewitt had a valid claim against Counsellors or Advisors for its post March 25 services.

CONCLUSION

For the foregoing reasons, the order of the district court should be affirmed.

Respectfully submitted,

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December 1974

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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I hereby certify that on December 2, 1974, I served, by United States mail, postage prepaid, two copies of the Memorandum of the Securities and Exchange Commission, Appellee in the above case, and one copy of the Commission's Supplemental Appendix, upon the following persons:

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